Ronald Reagan Presidential Library
Digital Library Collections

This is a PDF of a folder from our textual collections.

Collection: Bailey, Norman: Files
Folder Title: South American Policy (January 1983-May 1983)
Box: RAC Box 2

To see more digitized collections visit:
https://www.reaganlibrary.gov/archives/digitized-textual-material

To see all Ronald Reagan Presidential Library inventories visit:
https://www.reaganlibrary.gov/archives/white-house-inventories

Contact a reference archivist at: **reagan.library@nara.gov**

Citation Guidelines: https://reaganlibrary.gov/archives/research-support/citation-guide

National Archives Catalogue: https://catalog.archives.gov/

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name BAILEY, NORMAN: Files

Withdrawer KML 8/30/2011

File Folder SOUTH AMERICAN POLICY (JANUARY-MAY 1983)

FOIA M10-353/1 DENNISON 5

Box Number 2

ID	Doc Type	Document Description	No of Pages	Doc Date	Restrictions
117631	PAPER	RE GUYANA	7	1/6/1983	B1 B3
117633	PAPER	RE BOLIVIA'S FOREIGN POLICY	14	5/1/1983	B1 B3

The above documents were not referred for declassification review at time of processing

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name
BAILEY, NORMAN: Files

Withdrawer
KM 8/30/2011
L

File Folder
SOUTH AMERICAN POLICY (JANUARY-MAY 1983)

FOIA
M10-353/1
DENNISON

Box Number
2

5

ID	*Document Type* / *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
117631	PAPER RE GUYANA	7	1/6/1983	B1 B3

The above documents were not referred for declassification review at time of processing

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

8

~~LIMITED OFFICIAL USE~~

BUREAU OF INTELLIGENCE AND RESEARCH

ASSESSMENTS AND RESEARCH

YOUR PERSONAL USE PRIOR TO APPROVAL FOR WIDER DISTRIBUTION. DO NOT FURTHER REPRODUCE, DISTRIBUTE, OR CITE IN LISTINGS OF FINISHED INTELLIGENCE.

(U) CHILE: FROM THEORY TO PRACTICE--MORE FLEXIBILITY IN ECONOMIC POLICIES[1/]

Summary

Recent changes in Chilean economic policy do not represent an abandonment of the free-enterprise, market-oriented model of the so-called Chicago boys. The changes are merely an adjustment designed to mitigate the negative impact of a prolonged domestic and international recession. The result will be greater pragmatism and increased flexibility in the policy's application.

By late 1981 it had become clear that the Chilean economy was in deep trouble. Unemployment soared, while bankruptcies and bank failures proliferated. In response, President Augusto Pinochet enacted measures to help domestic industry, devalued the peso by 18 percent in June 1982, and went to the International Monetary Fund (IMF) for assistance. When these measures failed to produce the desired result, Pinochet again changed Economic Ministers, floated the peso, and embarked on even more dramatic departures from the strict free-enterprise policies that had been the hallmark of his administration.

The market-oriented approach proved notably successful in such areas as tax collection, bureaucratic efficiency, nontraditional export promotion, resource allocation, wage and price stability, social programs, and oil exploration and

1/ This report is based on a study prepared by Dr. Paul E. Sigmund of Princeton University under contract with the Department of State. Findings and conclusions expressed herein are those of the author and do not necessarily represent official Department of State policy or views. Copies of the study can be obtained from Kenneth E. Roberts, INR/LAR, 632-1252.

~~LIMITED OFFICIAL USE~~

Report 532-AR
January 11, 1983

production. Where the approach seemed to have gone wrong was in its rather doctrinaire adherence to a fixed exchange rate, its unwillingness to control private borrowing from abroad, and its lack of concern that the "automatic adjustment" process was producing skyrocketing interest rates, bankruptcies, and high unemployment. More fundamentally, a lack of government support for domestic saving and investment may have done lasting damage to the productive capacity of Chilean industry and agriculture.

The Chilean economy remains deeply depressed, but the political impact of an indefinitely prolonged slump is uncertain. The military is restrained from forcing a more nationalist, state-oriented economic approach because of Pinochet's powers over transfer, promotion, and retirement. Civilian industrialists and nationalists have produced some opposition leadership, but in a pinch they generally have fallen in behind General Pinochet. The centrist Christian Democratic Party has suffered the death of its most charismatic leader, Eduardo Frei, and members of the left are still tightly controlled or in exile. Thus, in the absence of a viable alternative, the Pinochet government is likely to remain in power for some time to come despite a considerable drop in support directly related to its economic policies.

* * * * * *

Mixed Success: The Experiment Refined

The appointment of Rolf Lüders in August 1982 to the joint post of Minister of Finance and Minister of Economy and the removal of two powerful army officers in key government economic positions mean that Chile's emphasis on free-market economic policies will continue but with greatly increased flexibility in their application. There have been a number of departures in recent months from the strict noninterventionism of the earlier Pinochet years. These changes, and the cabinet reshuffle itself, were undertaken in response to Chile's seriously depressed economy.

No changes were made in tariff policy but stricter enforcement of anti-dumping countermeasures were announced. The free float of the dollar was replaced by the so-called dirty float, which allowed the government to intervene to keep the dollar exchange rate for banking purposes within a 2-percent band around a high initial rate of 66 pesos to the dollar until April 1983, with monthly devaluations if Chilean inflation outpaced that of its trading partners. "Soft" government loans were announced to encourage exports, agriculture, and construction, and public works programs were initiated to create 100,000 new jobs.

Increased government spending and the successive devaluations soon began to have an inflationary effect. Most observers predicted that the inflation rate would rise by at least 20 percent in 1982 and a possible further 30 percent in 1983. Since wage increases were limited, losses of real purchasing power of 20-30 percent were predicted for the wage and salary sectors.

Lüders' overall strategy has been to use devaluation, credit policy, and the limits on wage increases to increase exports and reduce imports, while stimulating employment and the domestic economy by targeted government spending. Longer range objectives include a tax reform to encourage domestic saving and investment, aid to small and medium-sized businesses and agricultural enterprises in financial difficulty, and government assistance in the promotion of large-scale investment projects. Lüders admits that only one-third of Chile's balance-of-payments problems is due to external causes (the low price of copper and international interest rates), but he uses this as an argument that the bulk of the difficulties could be resolved by changes in domestic economic policy.

Part of Lüders' strategy was the decision to use as much as $550 million of Chile's $2.9 billion reserves in the last quarter of 1982 to prevent a balance-of-payments crisis, and an additional

$485 million in 1983, in the hope that a decline in international interest rates, a more favorable Chilean trade balance, and an Inter-American Bank loan and two large IMF credits totaling almost $900 million would enable Chile to resolve its balance-of-payments problem.

The Chicago Model Installed

Lüders' effort to correct the imbalances caused by his predecessors' rigid adherence to the Chicago model must be seen in the context of Chilean economic policy since 1973. The coup that ousted Salvador Allende led to a dramatic reversal of economic policy in Chile--a rejection of both the mixed economy model of the Christian Democrats (1964-70) and the statist socialism of the left (1970-73). Instead, the new military junta, led by General Pinochet, turned to the policy prescriptions of the free-enterprise oriented economists of Santiago's Catholic University, who had been trained at the University of Chicago by Milton Friedman and Arnold Harberger. A number of measures were taken to reorient the economy:

--Most price controls were removed, and agricultural producers were encouraged by higher, uncontrolled prices to expand their production, thus substantially reducing the burden of foreign exchange needed to pay for food imports ($600 million in the last days of the Allende government).

--Interest rates were freed from government controls.

--The complicated exchange rates of the Allende system were simplified to three rates and later to a single rate.

--A new tax system, indexed to inflation, was introduced to avoid the speculation on inflation that had characterized the old system. New measures were taken to ensure more efficient collection.

--Foreign investment was encouraged by a 1974 law that provided for tax stability and repatriation of profits; and, after lengthy negotiation, the copper companies were compensated for their holdings which had been nationalized in 1971.

--Industrial and agricultural holdings that had been seized or taken over on a dubious legal basis were returned to their owners, and others that had been taken over legally were sold to the highest bidder.

--Tariffs, which had sometimes reached 500 percent and had averaged 94 percent, were reduced in an effort to promote competition and efficiency. By 1979 tariffs had dropped to 10 percent.

The government strategy to reduce the inflation rate was only partially successful. The official rate--more than 600 percent at the end of 1973--dropped in 1974 to 375 percent. Government deficits continued, however, and the foreign balance-of-payments account in 1974 was hit with two blows: a sharp drop from $1.40 to 60¢ a pound in the price of copper, Chile's principal export, and the first Organization of Petroleum Exporting Countries (OPEC) increase in the price of imported oil. (At the time, about 75 percent of Chile's oil was imported. Oil exploration and production have increased, however, so that Chile now produces 45 percent of its needs.) By early 1975 it was apparent that more drastic measures had to be taken to prevent another surge in inflation.

In March 1975, Milton Friedman advised adopting a "shock treatment" similar to the one implemented by Ludwig Erhard in Germany in 1948 which had paved the way for the German economic miracle. In April 1975, the newly appointed Minister of Finance, Jorge Cauas, who had made massive cuts (15-25 percent) in the budget, fired thousands of public employees (the number of public employees was cut in half between 1973 and 1977), raised taxes drastically, and sharply reduced the government deficit and the rate of expansion of the money supply. Such state enterprises as railroads and electricity were required to become self-financing by charging realistic rather than subsidized prices and increasing the efficiency of their operations. The sell-off of nationalized enterprises in the private sector was accelerated.

As in postwar Germany, a currency reform was instituted. Interest rates paid, which in view of the high inflation rates that still prevailed (340 percent in 1975) had been negative, turned around immediately and by mid-year reached a real rate of 10 percent a month, later subsiding to a real rate of 15 percent for the year.

The result was a sharp contraction of the whole Chilean economy. Unemployment rose to more than 16 percent, industrial production dropped by 14 percent, and the gross national product (GNP) fell to minus 11 percent. The government deficit dropped to 3 percent of the gross domestic product (compared with 23 percent in 1973 and 10 percent in 1974), and by 1976 the balance of payments, which had been negative since the late 1960s, showed a surplus.

The new policy produced a sharp drop in public investment. The slack was not taken up by private investors because Chile was in recession and interest rates charged were astronomical. Thus, efforts were made to encourage foreign investment, including guarantees of profit repatriation and a stable tax rate. With a small market of 10 million, only about a third of whom participated in the modern economy, foreign investors did not rush to invest in Chilean industry.

Beginning in 1976, Chile turned therefore to private banks, now awash with petrodollars, to secure medium-term loans. The interest rates were higher than those charged by such multilateral financial institutions as the World Bank, but there were no problems with human rights conditions or opposition from European governments hostile to the Pinochet government.

In 1978 the net inflow of foreign capital increased sharply and foreign investment rose, most of it in mining and banking. While public sector borrowing was controlled, foreign borrowing by the private sector increased greatly over the next three years. The public external debt dropped from $4.4 billion in December 1977 to just over $4 billion two years later, but new private sector external debt rose from $430 million in 1977 to more than $1 billion in 1979 with a further jump by $2.4 billion in the next two years. Private bank borrowing skyrocketed from $147 million in 1977 to $2.7 billion in 1981.

The freeing of interest rates did not make the adjustment process easy. Spreads between interest charged and interest paid rose to 50 percent a year in real terms in 1976 and then gradually declined to 17 percent in 1978. However, the central objective of the shock treatment--bringing down the inflation rate--was achieved in dramatic fashion. The inflation rate was halved each year from 1975 to 1978, dropping from 340 percent to 30 percent over the four years. At the same time, the growth rate turned around. From negative 11 percent in 1975, the economy began to grow at rates of 4.1 percent in 1976, 8.6 percent in 1977, and 7.3 percent in 1978, by which time observers were beginning to talk of a "Chilean economic miracle."

<u>The Chicago Model in Trouble</u>

When Pinochet won the plebiscite on the Constitution (and his own election as President until 1989) by a 2 to 1 vote in 1980, it seemed that the regime could press forward without significant challenge to its economic plans. The "Chicago boys" were riding high:

- --The inflation rate took a sharp drop in late 1980 with the wholesale price index even showing a decrease for the first time in three decades.
- --Wages finally returned to their 1970 levels, averaging in real terms nearly twice what they had been in the mid-1970s.
- --The unemployment rate dropped to 9 percent in Santiago, its lowest since 1973.
- --Government expenditures for social purposes were increased and were targeted more effectively on those in extreme need

14

and on early medical and nutritional care, abandoning the earlier pattern of across-the-board subsidies.

--Such nontraditional exports as paper, lumber products, fishmeal, and fruit expanded, thus reducing Chile's dependence on copper.

--Imported goods were widely available at low prices because tariff rates for all items except large cars had been set at a fixed 10 percent since 1979.

--The economy was still growing at a 6-8 percent rate, and the adoption of a new mining code that gave further guarantees to foreign investors encouraged foreign mining companies to make ambitious investment plans.

It seemed that the "Chicago boys" had turned the economy around--just as they had promised in 1975.

Yet the Chicago model contained certain internal inconsistencies that ultimately led it into serious difficulty. In his zeal to bring inflation down, Finance Minister Sergio de Castro insisted on no further devaluation of the peso against the dollar after June 1979. When the US began to follow a tight money policy and the dollar rose by about 15 percent against European currencies, the peso rose with it, and Chilean exports to European markets became more expensive.

The cost of Chilean exports even rose against the dollar, because the 1979 and 1980 inflation rates in Chile were much higher than those of the US. Exports to the US (15 percent of Chile's exports) therefore became less competitive and imports (24 percent), more expensive. In addition, as the economy boomed, wages went up in excess of productivity, thus further reducing international competitiveness. The problem was intensified in 1979 by the flat 10-percent rate for tariff protection of Chilean domestic products. Because their costs were higher, Chilean producers could not compete with foreign imports. In 1981 alone, 433 of them went bankrupt.

The orgy of foreign buying (imported car sales, for example, rose from $40 million in 1978 to $372 million in 1981) plus rising international interest rates meant that the economy began to run a huge balance-of-payments deficit--more than $4 billion in 1981. It could only be financed by further borrowing at rates then hovering at 17 percent, readjustable every six months. By the end of 1981 the Chilean debt stood at $16.5 billion, $11 billion of it in private indebtedness, $4 billion with maturities of less than one year, and $12.5 billion in medium- and long-term debt.

To pay for that borrowing, Chileans competed for dollars and paid for them in pesos. Under the fixed-exchange system, however, the money supply was linked to the inflow of foreign reserves, which began to drop because of the balance-of-payments problem. The international imbalance increased uncertainty because it seemed likely that the peso would soon be devalued, despite the government's frequent assertions to the contrary. All this meant that interest rates, which in late 1980 had briefly dropped to an annual real rate of 5.7 percent (for dollar borrowing), rose to a real rate of 40 percent. This placed great strains on the financial system and on such interest-sensitive areas as housing and construction.

The world recession of the early 1980s meant that the price paid for Chile's principal export, copper, dropped from $1.33 a pound in 1980 to a 40-year low of 59¢ a pound in early 1982--wreaking havoc with foreign-exchange budgets. Other exports including silver, fruit, woodpulp, and fishmeal also suffered. At the same time the cost of imported petroleum (55 percent of Chilean consumption) had risen as a result of the 1979 OPEC price increase.

The financial collapse of a major sugar company in May 1981, the largest bankruptcy in Chilean history, followed by the government takeover of eight bankrupt banks and financial institutions in November, indicated how fragile the Chilean economy was. By late 1981 the economy was in deep trouble--as deep as in 1975 but this time not as the result of conscious government policy. Unemployment rose to 19 percent in early 1982 and 23 percent by mid-year. Major textile companies went bankrupt, reducing the number of firms from 190 to 41 and costing 40,000 jobs. Three hundred other companies went bankrupt in the first half of 1982.

In the metal industry, one-third of the workers were laid off and sales dropped 47 percent. Industrial production fell by nearly 14 percent in the first three months of 1982, and the government was forced to raise taxes and cut back on expenditures, thus worsening the recession. Imports dropped as foreign exchange became scarce. The current account for international trade came back into balance in mid-1982, but the damage was so great that pressure built up for a change in economic policy.

The government blamed its difficulties on low copper prices and the world recession, but the opposition both on the right and in the center argued that dogmatic adherence to a fixed exchange rate and excessively low tariffs were to blame. They maintained that a policy of selective protection for domestic industry and agriculture, encouragement of labor-intensive investment, and Keynesian-type promotion of domestic demand would have been a more successful policy than total reliance on an open economy and comparative advantage--the latter especially difficult to maintain

when the exchange rate made exports so expensive and imports so cheap.

They cited the policies of Korea and Brazil, where the promotion of national industrialization and exports and selectivity concerning the entrance of foreign investment had been more successful than total opening to (sometimes subsidized) foreign competition. Particularly critical, in their view, was the lack of new investment and the reduction in national industrial and agricultural capacity caused by bankruptcies.

The left, mostly in exile but also present in muted ways through such institutions as the Academy of Christian Humanism, also argued that the recession was the consequence of an inadequate concern for domestic demand and the skewed income distribution that resulted from a policy that favored large financial groups and the concentration of income. The increase in the foreign debt was also criticized as opening Chile to further dependence on external forces and increasing its debt service ratio (the ratio of interest and amortizations to current export income) to 45 percent for 1981 and much higher for 1982.

Another difference between what the government called the "recessive adjustment" of 1981-82 and the shock treatment of 1975-76 was the open opposition of major business groups to the government policy. Business opposed the low tariff policy, pointing out that the flat 10-percent rate (except for large cars) meant that foreign-produced luxury goods could be imported cheaply, while such investment inputs as tractors, which had been duty free, now were dutiable.

The business groups argued that tax policies should be devised which encouraged long-term investment instead of financial speculation and that the government should still play some role in a recessionary situation to stimulate the economy through housing and public works--and through taking action to bring down interest rates. Some even advocated a combination of tariff protectionism and fixed interest rates which involved the complete abandonment of the Chicago model.

Regardless of their ideological position, nearly all the critics were in agreement:

--that the current policy had hurt domestic industry (which by one estimate had dropped from 30 percent to 20 percent of GNP) and agriculture (because of high interest rates and dependence on unstable export markets);

--that unemployment was unacceptably high even under the best of circumstances and now was at a record level; and

--that the soaring Chilean foreign debt had been incurred by financial consumption and speculation rather than genuine investment.

The reply of the "Chicago boys," besides blaming international interest rates and the worldwide recession, emphasized the self-adjusting character of their model. They noted that imports had dropped off rapidly as the economy had run into trouble and predicted that the high domestic interest rates would not persist because they would attract foreign money into Chile which would force the rates down.

Cabinet and Policy Changes

Yet when the rates did not go down, the money supply contracted, and the economy slipped deeper into recession, Pinochet finally felt it necessary to take action. On December 4, 1981, he increased the number of military members of the Cabinet. This was followed by measures to help domestic industry, notably the application of "anti-dumping" regulations against foreign imports. More significantly, in April 1982 Sergio de Castro, Finance Minister since 1976 and leader of the "Chicago boys," was forced out of office. He was replaced by another Chicago-trained economist, Sergio de la Cuadra. But General Luis Danus, the new Economics Minister, began to play a more prominent role in economic policy.

It was Danus and not de la Cuadra who announced a surprise 18-percent devaluation in early June (immediately after a public speech by Pinochet insisting that no such action was contemplated) combined with further mini-devaluations and a link of the peso to a basket of foreign currencies rather than only to the dollar. The basis of the computation of wage adjustments was altered to lower the government-imposed floor on wage increases, and banks were permitted to make loans based on their holdings of foreign funds in order to reduce interest rates.

For the first time in several years the Chilean Government went to the IMF for loans. Abandoning the de Castro approach, the Central Bank also announced that it would take measures to assure that the money supply would grow by 11 percent in the remainder of the year (it had shrunk by 10 percent during the first part of 1982).

In early August the Chilean peso was allowed to float against other currencies. The defenders of the government argued that the abandonment of the fixed exchange rate was not a violation of Friedmanite principles but only a recognition that export prices had become misaligned, and a way to prevent reduction of wages as the effects of the continued negative wholesale price index rate (based mostly on imports) worked their way through the

economy. It was clear, however, that the doctrinaire noninterventionism of the de Castro policy had been jettisoned and a more pragmatic economic program adopted.

One effect of the financial crisis had been a huge increase in the number of bank loans that were in actual or threatened default--estimated at a total of nearly $1 billion dollars or more than half of all outstanding loans. To avoid a collapse of the banking system, the Central Bank announced in July that it would take over these debts under an arrangement whereby the private banks would have 10 years to pay off the outstanding amounts in 6-month installments.

Each bank was obliged, however, to negotiate an individual agreement with the Central Bank--part of which would involve "cleaning-up" of accounts including the reduction of loans to "interested parties," i.e., those who were directors or otherwise related to the bank, to a total of 5 percent of outstanding loans and 2.5 percent by 1984. The leading financiers complained about "the Chicago way to socialism," but their economic situation was so difficult that they had no choice except to comply.

Another group with a broader political base, the middle-class borrowers who had taken advantage of lower international interest rates to borrow in dollars, faced a large increase in debt repayments because of the devaluation and float. In another departure from its Chicago principles, however, the government announced that it would allow debtors to buy dollars from the Central Bank at the pre-float (but post-June devaluation) rate of 50 pesos to the dollar.

The alienation of groups that had previously supported Pinochet, the soaring unemployment rate which reached 23 percent in Santiago and now included such professionals as engineers (40 percent unemployed) and architects (60 percent unemployed), the continuing high rate of bankruptcies (403 in the first half of 1982), the paralysis of the construction industry, and the uncertainty that those in charge of economic policy knew what they were doing--all contributed to undermining confidence in the Pinochet government. As the newly floated peso rose from 46 to nearly 70 to the dollar, it became clear that something even more dramatic had to be done.

<u>The August Cabinet Reshuffle</u>

On August 26, Pinochet appointed Rolf Lüders to the joint post of Minister of Finance and Minister of the Economy. Pinochet also removed the two most powerful generals in the economic area--General Gaston Frez in the Planning Office (ODEPLAN) and Frez' brother-in-law, Economics Minister Danus--thus ending what had

been reported to be a continuing disagreement between the Chicago line of Sergio de la Cuadra in Finance and the more nationalistic orientation of the two generals. The general who was Secretary of the Government was replaced by a civilian who had been Minister of Mining, and de la Cuadra's associate, Miguel Kast, was replaced as head of the Central Bank by Carlos Caceres, the Dean of the Business School of Santa Maria University in Valparaiso and generally regarded as a corporatist nationalist hardliner in his political thinking.

The Lüders appointment, along with that of Alvaro Bardon as Under-Secretary of Finance, indicated that overall Chicago emphasis on a market economy would be continued but on a more flexible basis. Lüders was a former Dean of the Economics School at Santiago's Catholic University and a University of Chicago Ph.D. in economics. He was a frequent contributor to the press, criticizing the specific lines of the de Castro economic policy while supporting its overall goals.

The new superminister announced a number of policy changes which amounted to further departures from the strict governmental noninterventionism that had been followed earlier. Lüders' policy seemed to mark a significant departure from the ideological dogmatism of de Castro and de la Cuadra in the direction of greater willingness to use the instruments of government--without, however, adopting protectionist economic policies.

<u>Future Prospects</u>

As the Chilean economy remains deeply depressed, key questions for the future are posed by the prospect of an indefinitely prolonged slump:

--Can Lüders' policies revive the economy or will dissident elements in the military demand a more nationalist and statist economic approach, perhaps forcing Pinochet out in favor of a corporatist nationalist?

--Will the continuing economic crisis lead to a general disillusionment with political power by military leaders, as occurred in Peru in the mid-1970s, leading them to consider turning power over to an "acceptable" civilian, such as a representative of the traditional industrial right associated with former President Jorge Alessandri?

--Will a gradual international economic recovery and a more flexible domestic policy enable Pinochet to overcome his critics and remain in office until the end of his "constitutional" term in 1989--and perhaps even be reelected by plebiscite until 1997?

The problem with evaluating the alternative scenarios is that no one is sure who the actors will be. The military is subject to Pinochet's powers of transfer, promotion, and retirement. The industrialists and the nationalists have had some civilian leaders, but when pressed they generally have supported Pinochet. Only retired Air Force General Gustavo Leigh has seemed ready to challenge the regime's policy on populist-nationalist grounds.

The centrist Christian Democratic Party has suffered the loss of its most charismatic leader, ex-President Eduardo Frei, who died in January 1982. And although its new leader, ex-Foreign Minister Gabriel Valdes, has had good personal contacts with both the center and the left, he is opposed by the right. The left is still tightly controlled or its members are in exile and forbidden to return.

However prolonged or difficult the economic crisis becomes, therefore, the lack of a viable alternative seems to indicate that the Pinochet government will remain in power for some time to come--despite a considerable erosion in support caused by its economic policies.

Prepared by Kenneth Roberts and William Lofstrom
x21252 x22367

Approved by William J. Trainor, Jr.
x20805

~~LIMITED OFFICIAL USE~~

DL 8/30/11

2

THIS ADVANCE COPY IS PROVIDED FOR YOUR PERSONAL USE PRIOR TO APPROVAL FOR WIDER DISTRIBUTION. DO NOT FURTHER REPRODUCE, DISTRIBUTE, OR CITE

So Am

BUREAU OF INTELLIGENCE AND RESEARCH

•

ASSESSMENTS AND RESEARCH

(U) BRAZIL-AFRICA ECONOMIC RELATIONS: BATTERED BY GLOBAL RECESSION AND THIRD WORLD DEBT[1/]

Key Judgments

Brazil's efforts to advance its economic ties with sub-Saharan Africa suffered a severe setback in 1982. Exchanges of missions, new initiatives, and trade fell off badly. Nigeria, Brazil's major African partner, imposed import curbs after oil prices dropped sharply and its debt crisis intensified. International recession and lower commodity prices left other African nations less foreign exchange with which to purchase Brazilian goods. Brazil, because of its own credit shortage, foreign debt problem, and import curbs, and in view of dim African economic prospects, became less willing than before to take risks and less able to make competitive offers for the business that remained.

Thus, despite earlier hopes and predictions, Brazil will not be, in the near term, a major competitor in Africa for trade, investments, finance, or services. The potential is still there, but the time frame has lengthened considerably. Economic relations over the next five years will be limited to the most profitable partners--primarily Nigeria, Gabon, Angola, South Africa, the Congo, and perhaps Mozambique. These countries can sell Brazil natural resources, mostly oil, in return for manufactured products or services.

1/ This report is based on a paper prepared by Wayne Selcher of Elizabethtown College under INR's Scholar-Analyst program. It complements INR Report 440-AR, "Policy Dilemmas in Brazil-Africa Relations: A Bellwether for Future South-South Ties?" (LIMITED OFFICIAL USE), August 3, 1982. Copies of the full study on Brazil-Africa ties can be obtained from Kenneth Roberts, INR/LAR, 632-1252.

~~LIMITED OFFICIAL USE~~

Report 607-AR
April 27, 1983

The declining attractiveness of the Third World trade option may encourage Brazil to assign more importance to its relationship with the developed, industrialized economies, but the result is not likely to be abandonment of its Third World identification and goals. Brazil's African experience shows both the possibilities and the considerable limitations of bilateral cross-continental South-South relations: the concept is attractive politically, but lack of institutionalized relationships and financial resources makes it vulnerable to negative international economic trends and casts doubt on its usefulness as an engine for developing countries' growth or recovery.

* * * * * *

South-South Ties: Catalyst for LDC Growth?

For the past decade, Brazil has viewed South-South ties (especially the more intense economic relations) as a dynamic growth area from which it (as a middle-income, newly industrializing, resource-rich country) was in an excellent position to benefit. Initial results of Brazil's strategy to promote these ties were impressive and corroborated this view: In the 1975-80 period Brazil's trade value with oil-exporting less developed countries (LDCs) grew by 283 percent and with other LDCs by 302 percent. In contrast, its trade with Western industrial states (though starting from a larger base) grew by only 161 percent. Its 1980 turnover of $20.3 billion with LDCs represented 45 percent of its total trade.

Brazil's economic relations with sub-Saharan Africa, a region Brazil has given considerable official attention, provide a measure of the ability of a diversified LDC with a large industrial sector to provide the kind of products, services, technology, and finance needed by one of the Third World's poorest areas. In the 1975-80 period, Brazil's exports to the region increased from $141 million to $841 million; imports increased from $212 million to $892 million.

By 1982, however, serious limitations in the relationship were clear, imposed by negative economic trends in Brazil, Africa, and the international system. These trends cast doubt on many assumptions about the growth potential and benefits of not only Brazil-Africa ties but also South-South relations generally.

In 1982, Brazil's exports to sub-Saharan Africa declined 25.8 percent (from $1.353 billion to $1.004 billion). Its exports to Nigeria, its largest African customer, declined 68.3 percent (from $770.2 million to $244.2 million). Brazil's exports worldwide declined 13.4 percent.

Brazil's imports from sub-Saharan Africa in 1982 declined even more sharply, dropping 50.8 percent (from $1.332 billion to $656 million). Imports from Nigeria dropped 68.8 percent (from $728.5 million to $227.2 million). Brazil's total imports declined 12.2 percent.

Restraints on the Brazil-Africa Relationship

Brazil, in advancing its trade with Africa, has had to contend with the usual problems of breaking into a new and difficult market: established customer preferences, low recognition

for its own products, and competition with traditional suppliers and distribution networks. It has had to deal bilaterally with each partner (unlike France which, through various institutions and agreements, treats most of its former colonies as a single market). Brazil also has no need for most African agricultural products, to which the Europeans grant preferences. These preferences make it much easier for Europe to conduct a balanced trade with Africa.

Even with regular, direct air and sea routes from Brazil to West Africa, South Africa, Angola, and Mozambique, delays in delivery and lack of full return cargos in freighters still inhibit trade. The cost of maintaining offices in West Africa, particularly in Nigeria, has forced all but the largest and most determined companies to sell from Brazil through intermediaries, with periodic visits to the field.

Finance, however, more than any other consideration, holds up progress in Brazil-Africa economic relations. The usual mechanism is the supplier's credit extended by the Bank of Brazil's Foreign Trade Office (CACEX) at terms below normal commercial rates. A line of credit in millions of dollars is opened to a country for the purchase of manufactured products or services. The willingness to take risks has been central to Brazil's commercial competitiveness relative to US and European suppliers. Brazil's current debt situation, however, has sharply reduced its ability to provide favorable, flexible financing to African purchasers of Brazilian goods.

Finally, Brazilian exporters wanting to sell to the LDC market are much more likely to try Latin America than Africa because of proximity, tradition, and familiarity. Thus, governmental efforts by both Brazil and sub-Saharan African nations have run well ahead of the level of response from businessmen.

Brazil's Export Strategies

Brazil touts itself as an economic model to which African states can realistically aspire. It offers a tropicalized industrial system with technology and techniques that are close to Africa's experience and needs. Often in contrast to the northern industrial powers, Brazil specializes in sturdy, simple, and moderately priced products and projects. It emphasizes language and cultural ties in Angola and Mozambique and confirms political affinity through a Third World stance, willingness to do business with Marxist regimes, and a policy of non-interference in internal affairs.

Government promotions, official visits, supplier's credits, commercial delegations, and tax subsidies have been crucial to

Brazil's African venture. Government agencies promoting Brazilian exports typically establish an overall bilateral framework through a set of treaties, although many of these agreements subsequently receive little implementation. In the more dynamic instances, binational commissions meet annually, but execution usually falls well behind conceptualization. Brazil currently has such joint commissions with Angola, Cape Verde, Congo, Gabon, Guinea-Bissau, Ivory Coast, Mozambique, Nigeria, Senegal, and Zaire.

Most Brazilian enterprises do not have the range of prerequisites to make a successful entry into Africa. A common strategy is to seek partnerships with firms from other countries that are breaking into the African market. Multinationals from the UK, France, Portugal, and Japan are unlikely candidates because of their operating style or concern about competition, but Canadian, Soviet, and Chinese firms have shown interest in African joint ventures with Brazilian companies.

To secure long-term relationships with African petroleum suppliers, Brazil's state oil company Petrobras is seeking to produce crude, through its subsidiary Braspetro, in joint ventures in the Congo and with the state oil company of Angola. Talks are in various stages concerning similar operations elsewhere in Africa. The typical Braspetro package involves production rights, payment in oil for services, and training of local personnel. If successful, such arrangements will expand Africa's role as a petroleum supplier to Brazil and a customer for its refined petroleum products.

The provision of technical assistance services by Brazil to Africa is relatively new, but a promising vehicle for growth. Brazil does not possess sufficient capital to carry on major foreign investment *per se*, but its largely tropical climate and income level make its innovations and what it has absorbed from technology exporters quite relevant to African development projects. The companies involved are largely private firms in the fields of consulting, project design, agriculture, mining, and civil construction. A joint venture with a local firm often is the format adopted, with an emphasis on training local workers and technicians. As of 1982, about six Brazilian services companies maintained offices in Nigeria.

Brazil's African Experience--A Mixed Record

Despite the impressive growth rates of trade and services before 1982, Brazil's African venture barely got off the ground. Total value of trade in 1981 was less than $3 billion. Brazil-Africa trade has been both concentrated and erratic, symptomatic of an only partially institutionalized relationship that suffers from insufficient resources and conflicting higher priorities on both sides.

The first time an African country broke into the ranks of Brazil's top 10 partners was in 1981, when Nigeria accounted for 3.3 percent of Brazil's foreign trade (ranking eighth in both imports and exports and surpassing the UK as a customer). Trade with other African partners has been more sporadic and based largely on ad hoc exchanges or one-time deals where, for a particular purchase, Brazil offered the best package.

Even in the successful years of 1980 and 1981, the number of African countries carrying on a meaningful level of trade with Brazil was a small fraction of those in the sub-Saharan region. The principal 1980 markets, covering 92 percent of Brazil's sales to Africa, were Nigeria ($271.5 million), Angola ($118.7 million), Zaire ($105.9 million), South Africa ($103.1 million), Mozambique ($72.3 million), Liberia ($43.6 million), Congo ($35.8 million), and Ivory Coast ($30.2 million). In 1980, Brazil ranked 12th as a purchaser of African goods and 13th as a supplier, up from 21st and 24th places in 1975. Still, trade with Brazil remained at less than 2 percent for both the region and Nigeria.

Eighty-eight percent of Brazil's exports to Africa in 1980 were manufactured of semi-manufactured goods (e.g., transportation equipment, petroleum derivatives, processed food, textiles, machinery, iron and steel, and paper). In the 1970s sales in these categories grew by an average of 48 percent yearly, but they suffered the heaviest losses in 1982. In substantial measure, the flow of Brazilian manufactures to Africa is a function of foreign investment in Brazil as a channel for multinational sales to Africa. Brazilian affiliates figuring largest in the Africa trade include Volkswagen (a major supplier of unassembled vehicles to Nigeria), Mercedes-Benz, Saab-Scania, Massey Ferguson, Caterpillar, and General Electric.

Petroleum (from Nigeria, Gabon, Angola, and Congo) increasingly has been Brazil's most important import from Africa, making up 61 percent of Brazilian import value in 1980 and 89 percent in 1981. Other major imports include phosphoric acid, asbestos, lead, and nickel (South Africa), graphite (Madagascar), natural rubber (Liberia and Nigeria), copper ingots (South Africa, Zambia, and Zaire), aluminum (South Africa and Ghana), zinc (Zaire), manganese (South Africa and Gabon), and chromite (Mozambique). Large purchases of coking coal from Mozambique are being negotiated.

Prospects

Despite the disappointing reversals of 1982, Brazil still has the potential for being an important commercial competitor in Africa. But the time frame has lengthened considerably. Over the next five years, the limits already experienced will be more restrictive and progress will be more costly. To remain

competitive, Brazil must improve its knowledge about African markets and establish an organized followup capability to retain or expand its market shares. The trade that survives will have to do so with less stimulation of promotional marketing and cheap credit.

Because of its own limitations, Brazil in the future must be more selective in its consideration of each partner's longer term ability to pay. In effect this will restrict close relations to those countries with oil and minerals needed by Brazil. Key partners will remain essentially the same--Nigeria, Angola, South Africa, Congo, Gabon, and perhaps Mozambique. Economic relations with East Africa and such former minor partners as Ghana and Senegal will bring meager returns. Relations with such countries as Ivory Coast, Togo, and Zaire will depend on their unpredictable economic health and the results of further explorations for oil.

Because the Third World option is currently less attractive than it was two or three years ago, Brazil may assign greater value to its First World ties. It will not give up completely its Third World identification and goals, however, and undoubtedly will continue to avoid any appearance of subservience to US interests.

Brazil's African experience should give it a greater realization of the limits of its foreign policy and economic resources. As a result, Brazil most likely will pay more attention to its economic relations with Latin America and other regions where the obstacles are less overwhelming and the prospects for shorter term reward are greater.

Prepared by Kenneth Roberts
632-1252

Approved by E. Raymond Platig
632-1342

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name	*Withdrawer*
BAILEY, NORMAN: Files	KM 8/30/2011 L
File Folder	*FOIA*
SOUTH AMERICAN POLICY (JANUARY-MAY 1983)	M10-353/1 DENNISON
Box Number	
2	5

ID	*Document Type* *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
117633	PAPER RE BOLIVIA'S FOREIGN POLICY	14	5/1/1983	B1 B3

The above documents were not referred for declassification review at time of processing

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.